Monthly Market Update

September 2024

Madison INVESTMENTS

Highlights:

- The S&P 500 Index rose 2.4% in August, bringing its year-to-date return to 19.5%, with broad stock returns outperforming the leading "Magnificent 7" stocks.
- The Federal Reserve indicated a shift towards lower interest rates starting in September, with a new focus on employment rather than inflation.
- Despite positive stock returns and market broadening, there is skepticism about long-term stability due to mixed economic signals and concerns over the labor market.

Americans with a stake in the stock market were once again rewarded in August, with the S&P 500 Index rising 2.4% for a year-to-date return of 19.5%. Bond investors were also pleased as medium and long-term interest rates dropped. Unlike much of the trailing year, stock returns were broad, outperforming results for the market-leading "Magnificent 7" stocks. These market returns were certainly a key factor behind consumer confidence ticking upward in August. Another positive for stocks was the dovish rumblings from the Federal Reserve's Jackson Hole meeting in late August, where Fed Chairman Jerome Powell basically announced a pivot to lower rates beginning in September as he described the Board's focus shifting from controlling inflation to concern over softening employment numbers.

While the positive stock returns, especially the broadening of the market, were welcome turns, we couldn't help but feel skepticism as the major stock indices toyed with new highs. A hint of this skepticism was seen in The Conference Board's consumer confidence surveys, where optimism was tinged with concern over the labor market. As we've noted in the past, the resilience of the economy in the face of the Fed's record-setting rate increases has been largely a function of a strong consumer. Early in the tightening cycle, fiscal stimulus and Covid checks bolstered this strength. Lately, it's been fueled by rising credit card debt and the wealth effect of the stock market for higher net worth households, with the Wall Street Journal recently reporting on the record number of 401(k) millionaires. This has helped to hide the damage the trailing inflationary period has wrought on American households with below-median incomes.

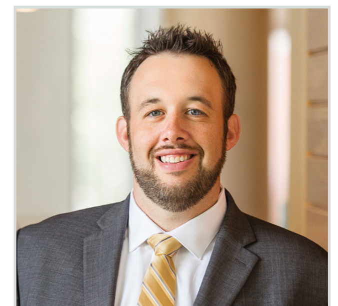
The surprising presidential candidate switch in August can serve as a harbinger of how quickly political and, by extension, economic situations can shift. The futures markets predict a 2% drop in Fed Rates by mid-2025, which, if realized, could be a real boost for future stock returns. However, in the past, such precipitous dips have only occurred in the midst of recessions. All around us are signs of economic slowdown as manufacturing measures for both demand and output dropped in August, the Labor Department revised trailing job growth down by 818,000, discount retailers reported sales and earnings declines, and even the hype over AI showed some slackening.

While monthly results do not always portend long-term trends, they can suggest shifts. In August, the long-leading Technology and Communication Services Sectors trailed the overall market while the more defensive Healthcare and Consumer Staples outperformed. The prospect of lower bond yields helped bolster the Utilities and Real Estate Sectors. These shifting fortunes highlighted our belief that the prospect of a more challenging economic period ahead doesn't require a sharp shift in asset allocation. Instead, it highlights the importance of the constitution of that equity allocation. Here, we seek to continue to build diversification through investments in solid businesses that are reasonably valued and well-situated for success through the inevitable ups and downs of a modern economy.

Portfolio Manager Q&A - Mike Sanders

At the latest Jackson Hole economic symposium, Fed Chair Powell mentioned that the time has come for policy to adjust. What did you take away from that speech, and what are Madison's expectations for the Fed's next course of action?

My biggest takeaway was that the Fed may be more concerned about the labor market than the other side of its dual mandate, inflation. The employment picture is worsening slightly, and their ability to achieve a soft landing may be more difficult if they don't adjust policy. That's why I think the next labor market release will be a significant driver in how much of a cut the Fed does in their September meeting.



Mike Sanders, CFA, FRM
Head of Fixed Income,
Portfolio Manager

What should investors expect for rate cuts for the rest of the year, and what does it mean for the back end of the curve and risk assets?

The market is currently pricing in a pretty quick path to a terminal rate of 3% - about nine cuts in total - and a 3% Fed funds rate by the end of 2025. Even more aggressively, four cuts through the end of this year in three meetings. Given the current economic environment and how good the economy seems to be doing, we think that's aggressive. From our perspective, if the Fed is aggressive and delivers those nine cuts, it likely means that the economy is struggling, which would also mean that risk assets would struggle. Where we are right now, in more of a soft landing scenario, it's hard to imagine the back end of the yield curve moving a lot from here. With the market already pricing in a 3% Fed funds rate, you'd have to have a harder landing for those longer-end yields to move lower. Managing risk becomes very important in this environment, given all the factors moving markets around.

Given the outlook you just described, how should investors think about maximizing yield?

I think investors have to be open and opportunistic with what the market is offering in terms of fixed income. Even though we've moved lower in interest rates, some areas within the fixed income market are still attractive. We still like financial corporate bonds, such as regional banks, that offer value given where spreads are. But I think maybe the most important thing about fixed income allocations today and how much risk you want to take is that if you look at a high-quality intermediate fixed income portfolio, yielding 4% to 5%, that's higher than where Fed funds rate likely ends up over the cycle. Even though interest rates have fallen slightly, investors can still own a high-quality fixed income portfolio, reduce their reinvestment risk, and lock in those yields above where the cash will likely pay.

So, how should investors think about active management and fixed income, and what should their expectations be given the current environment?

We believe active management is managing all fixed income risks to maximize opportunities and generate strong risk-adjusted performance. Especially when both rates and spreads are volatile, an active manager will assess where the value is across the market and move a client's portfolio into areas where they think there is the best opportunity for risk-adjusted performance.

For example, the market was pricing in six to seven interest rate cuts earlier this year. We didn't think that would happen, so we kept durations short relative to the benchmark in client portfolios. Interest rates rose throughout the year as better data came out, and in May, we thought there was an opportunity to push durations out and lock in those higher yields with the longer maturity bonds.

The market thought the Fed funds rate would be closer to 4%, compared to the 3% we thought it would be closer to. The market is constantly changing, spreads are always changing, and rates are always changing. It's up to active managers like ourselves to find and take advantage of those opportunities.

U.S. Equities (%)

	August	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	2.0	11.7	22.1	7.7	11.8	11.8
S&P 500	2.4	19.5	27.1	9.4	15.9	13.0
Russell 1000	2.4	18.6	26.6	8.3	15.6	12.7
Russell 1000 Value	2.7	15.1	21.1	7.3	11.2	8.9
Russell 1000 Growth	2.1	21.1	30.8	8.9	19.1	16.0
Russell Midcap	2.0	12.1	20.2	3.5	11.2	9.6
Russell 2000	-1.5	10.4	18.5	0.6	9.7	8.0

U.S. Equity Characteristics - S&P 500

	August	2023
Price/Earnings Ratio (NTM)	21.3	19.7
Weighted Avg. Market Cap ($B)	963.8	721.7
Dividend Yield (%)	1.3	1.5

U.S. Equity Sectors - S&P 500 (%)

	August	YTD	Weight
Communication Services	1.2	23.1	8.8
Consumer Discretionary	-1.0	6.4	9.7
Consumer Staples	5.9	17.7	6.0
Energy	-1.7	11.4	3.5
Financials	4.5	22.6	13.3
Health Care	5.1	16.3	12.2
Industrials	2.9	16.3	8.5
Information Technology	1.3	27.1	31.1
Materials	2.4	11.2	2.2
Real Estate	5.8	10.6	2.4
Utilities	4.9	22.6	2.4

International Equities (%)

	August	YTD	1 Year	3 Year	5 Year	10 Year
ACWI	2.5	16.0	23.4	5.8	12.1	8.8
ACWI ex USA	2.8	11.2	18.2	2.1	7.6	4.4
MSCI EAFE	3.3	12.0	19.4	4.1	8.6	5.2
Emerging Markets	1.6	9.5	15.1	-3.1	4.8	2.6
China	1.0	4.4	-2.8	-13.6	-3.4	0.5
Japan	0.5	13.0	19.7	3.8	8.1	6.4
Germany	4.7	12.7	19.9	0.8	7.3	3.9
United Kingdom	3.3	15.1	22.0	8.9	8.7	3.5
India	1.1	22.8	39.7	11.1	16.7	9.6

Key Asset Prices

	August	2023
EUR/USD	1.11	1.11
USD/CAD	1.35	1.32
USD/JPY	145.95	140.92
GBP/USD	1.31	1.27
Bitcoin ($)	58,969.9	42,265.2
Gold ($/oz)	2,521.0	2,066.0
Crude Oil (WTI) ($/bbl)	78.4	75.8

Fixed Income (%)

	August	YTD	1 Year	3 Year	5 Year	10 Year
Government Bond	1.3	2.6	6.0	-2.5	-0.6	1.2
Municipal	0.8	1.3	6.1	-0.5	1.0	2.4
U.S. Aggregate Bond	1.4	3.1	7.3	-2.1	0.0	1.6
Investment Grade Corporate	1.6	3.5	9.0	-2.0	0.6	2.5
High Yield	1.6	6.3	12.6	2.5	4.5	4.7

U.S. Treasury Yields (%)

	August	2023
3-Month	5.2	5.4
6-Month	4.9	5.3
2-Year	3.9	4.2
5-Year	3.7	3.8
10-Year	3.9	3.9
30-Year	4.2	4.0

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Non-deposit investment products are not federally insured, involve investment risk, may lose value and are not obligations of, or guaranteed by, any financial institution. Investment returns and principal value will fluctuate.

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In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Equity risk is the risk that securities held by the fund will fluctuate in value due to general market or economic conditions, perceptions regarding the industries in which the issuers of securities held by the fund participate, and the particular circumstances and performance of particular companies whose securities the fund holds. In addition, while broad market measures of common stocks have historically generated higher average returns than fixed income securities, common stocks have also experienced significantly more volatility in those returns.

The Dow Jones Industrial Average® (The Dow®), is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The S&P 500® Index is a large-cap market index which measures the performance of a representative sample of 500 leading companies in leading industries in the U.S.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 89% of the total market capitalization of the Russell 3000 Index.

The Russell 1000® Growth Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit growth characteristics.

The Russell 1000® Value Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit value characteristics.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 11% of the total market capitalization of the Russell 3000® Index.

The Russell Midcap® Index is a mid-cap market index which measures the performance of the mid-cap segment of the U.S. equity universe.

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The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The MSCI EAFE (Europe, Australasia & Far East) Index is a free-float adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada.

Emerging Markets - MSCI Emerging Market Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

China - MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

Japan - MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

Germany - MSCI Germany Index is designed to measure the performance of the large and mid cap segments of the German market.

United Kingdom - MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market.

India - MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market.

Government Bond - Bloomberg US Government Index measures the performance of the U.S. Treasury and U.S. Agency Indices, including Treasuries and U.S. agency debentures. It is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

Municipal - Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

U.S. Aggregate Bond - Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries,

government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

Investment Grade Corporate - Bloomberg U.S. Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

High Yield - Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Weighted Avg. Market Cap: measures the size of the companies in which the portfolio invests. Market capitalization is calculated by multiplying the number of a company's shares outstanding by its price per share.

Price-to-Earnings (P/E) Ratio: measures how expensive a stock is. It is calculated by the weighted average of a stock's current price divided by the company's earnings per share of stock in a portfolio.

Dividend Yield: the portfolio's weighted average of the underlying portfolio holdings and not the yield of the portfolio.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

A basis point is one hundredth of a percent.

Yield Curve: a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward-sloping curve), inverted (downward-sloping curve), and flat.

Duration is a measure of interest rate sensitivity. For example, a portfolio with a duration of three years would be expected to rise 3% if interest rates were to fall 1%. It is measured in years because it can also be used to measure the time it takes to recover one's original investment taking all cash flows into account.

The Magnificent Seven stocks are a group of high performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

The federal funds rate is the target interest rate range set by the Federal Open Market Committee (FOMC) for banks to lend or borrow excess reserves overnight. It influences monetary and financial conditions, short-term interest rates, and the stock market.

Diversification does not assure a profit or protect against loss in a declining market.

Upon request, Madison may furnish to the client or institution a list of all security recommendations made within the past year.

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